The Investor and the Industrial Enterprise

By Hon. George W. Norris
Farm Loan Commissioner, Washington, D. C.

THE average manufacturer, like most other business men, needs to use more money than he has. A part of this money he may reasonably expect to borrow from banks, but it is the business of banks to make "loans," as distinguished from "investments." In other words, a bank is supposed to make only such loans as the borrower may reasonably be expected to repay within a few months. A bank's loans are short-time loans. It is expected to keep its assets "liquid." Indeed, the Federal Reserve Banks are prohibited by law from re-discounting paper that is not "self-liquidating"—that is to say, paper that is issued in the course of a commercial transaction, ordinarily representing the price of goods which have been bought with the expectation, and in the probability, that they will be marketed within a few months, and that the proceeds of their sale will enable the maker of the note to pay it. It is not good banking for a bank to loan money to a manufacturer to be invested by him in land, buildings or machinery, because these are not things that he expects to sell, and he will therefore be unable to pay the loan at maturity, unless he can secure the funds out of the profits of his business, or in some other way. The funds cannot be secured from the sale of the articles which he bought out of the money secured by the loan. The money which goes into land, buildings or machinery, is capital permanently invested in the business, and if the manufacturer has to borrow this money, he should borrow it from an investor.

Investments in industrial enterprises have long been a well-established form of investment in several European countries, but in this country they are of comparatively recent development. The first investments made to any extent in corporate securities in this country were in turnpikes and canals. Subsequently, there came very large investments in railroads, and then in street railways, telegraph and telephone companies, gas companies, and electric light and power enterprises. Practically all of these

investments had the attraction for the investor of being something more than a mere industrial enterprise. They included a franchise and it was recognized that with the growth of population this franchise was likely to become increasingly valuable, so that even if mismanagement temporarily made the enterprise unprofitable, it was probable that other interests would take it up because of the possibilities of profit inherent in the franchise. Investments in purely industrial enterprises that had no franchise feature connected with them were first made on a large scale in connection with the consolidation of various enterprises in the same line of business. The so-called "Sugar Trust," to which the American Sugar Company succeeded, was one of the first of these consolidations. Subsequently, similar consolidations were made in many other industries. The promoters dwelt upon the advantages of consolidation; the ability to purchase raw materials in large quantities at low prices; the elimination of the less profitable plants and the reduction of overhead expenses by the concentration of manufacturing in the most economical plants; the ability to control prices; and the economy in distribution. In some cases, these expectations were realized. In the majority of cases, they were not. In all of them, very large amounts of securities were issued, which were listed on the stock exchanges, and the investors had the pleasure and excitement of anticipating large profits by the sale of their securities at higher prices, without waiting for the slower returns of dividends.

The single industrial establishment which has no franchise and whose securities are not issued in sufficient volume to justify their being listed on a stock exchange, does not have the attraction for either the real investor or the speculative investor that was possessed by either of the above classes. It is a business enterprise pure and simple. The investor in its securities cannot anticipate a ready market for them, nor can he hope to get his money back unless the enterprise is established on sound lines, is properly managed, and pays satisfactory dividends. In some cases, the place of a franchise is taken by a patent or trademark or copyright. Where there is no one of these things and the proposition is simply to manufacture textiles or pig iron or some other standard product, in open competition with every other manufacturer in the same line in the country, the enterprise is probably more

difficult to finance than any other class of enterprise, and the man who is going to run the business and wants to find outside capital, must expect to make attractive terms to the investor. He should be prepared to satisfy the investor that there is a market for the goods which he proposes to manufacture; that his plant is to be located in a suitable place, taking into account both the securing of his raw material and the marketing of his finished product; that he can secure an adequate supply of labor; that living conditions will be such as to enable him to hold this labor; that he can secure power at reasonable cost; and that, as a result of all these conditions, he will be able to conduct his manufacturing operations at a cost at least as low as the average of his competitors. He must also be prepared to satisfy the investor that the total amount of capital at his disposal will be sufficient to cover the cost of building or enlarging his plant, to carry him over the period of difficulties and delays incident to the establishment of a business, and to leave him sufficient working capital to conduct the business thereafter in the volume which is anticipated. If any one of these factors is wanting, he should not expect the coöperation of the investor—indeed, he should not enter upon the enterprise himself. If all these factors are present, there remains for consideration the general scheme of capitalization and the relative proportions in which the operator and the investor should share in the anticipated profits.

Just at this point there lies a rock upon which many enterprises have come to shipwreck. The investor, if not thoroughly experienced, is apt to stipulate for mortgage bonds, generally with a stock bonus added. His idea is that his money should be secured by a lien on the plant; that the interest on his money should be a first charge upon the profits of the business; and that if these profits are sufficient to pay him his interest and leave a large balance, he should share in the distribution of that balance. All this is very natural and very reasonable, but very dangerous. The world today is full of successful enterprises which either trembled in the balance for years, or actually "went bad" and had to be reorganized. Most of our railroads have been reorganized—some of them two or three times. The Welsbach mantle was a flat failure when it first came out and for years was supposed to be a total loss, until a supplemental discovery made

it a great commercial success. Most new manufacturing plants have what might be called "children's diseases." The plant cost more than was anticipated, or it took longer to build than was anticipated, or the first machinery that was installed did not work satisfactorily, or it was necessary to install other machinery to dry or shred or grind, or there was delay in getting the product introduced. Even in the case of a staple standard product or a business that has been in successful operation for years, there are almost certain to be periods of depression. This is a great country in which the tide of business rises higher and higher, but it has its periods of ebb. The business which is so capitalized that it can live through a period of depression will, when the period of prosperity comes, reward those who have waited for it, but the business which is handicapped by an annual fixed charge goes to the wall before the "boom" comes, and the unfortunate investors in its securities are wiped out. Therefore, the interests of both operators and investors require that no such burden be placed upon the business, or that the burden be made so light that it can be carried in even the worst of times. This means that the investor should be given preferred stock, upon which dividends may be passed if there are no profits, rather than bonds which call for interest in any event and for foreclosure if there are no profits to meet the interest.

The next thing to be borne in mind is that there should be some flexibility about the financial plan. It is bad practice, for example, to make an issue of $100,000 preferred stock, with a provision that no bonds or additional preferred stock can be issued without the consent of all or a large majority of the holders of the original preferred stock. This puts it within the power of a small minority, or even of a single stockholder, to prevent the corporation from securing additional capital that may be needed for the development or even for the preservation of the business. If $100,000 is sufficient for the original investment, the authorized issue of preferred stock should be made at least $200,000—preferably $500,000—with provisions that the additional stock is only to be issued by a majority vote and for actual value. This takes care of future growth. Many public utility companies in this country have actually been wrecked by their success. The communities in which they operated grew and it became necessary to extend

tracks, pipes or wires. There was, however, a closed first mortgage and no additional money for these extensions could be raised except upon a second mortgage, and second mortgage bonds were not marketable. The inevitable result was a denial of service, arousing the ill-will of the community and ultimately wrecking the company.

The investor who puts his hard cash into a business which he knows little or nothing about and which someone else, who is supposed to know all about it, is going to operate, is entitled to a preferred status. He should therefore be given stock preferred both as to assets and dividends. These dividends should be cumulative, so that if for a period of a year or more he is obliged to forego dividends, because the earnings are insufficient or because they are needed for the extension of the plant or for additional working capital, he shall receive these dividends in some subsequent year. The dividends upon preferred stock, however, are usually limited to 7 per cent, and where an investor makes an investment of such a character that he is likely to lose 100 per cent, if the business is a failure, he is fairly entitled to expect more than 7 per cent, if it is a great success. This situation may be met by making his preferred stock exchangeable, at his option, into common stock. If the company is earning enough to pay 7 per cent upon its preferred stock, and 10 per cent or 20 per cent upon its common stock, it is only fair to give the investor the right to forego his preferences, to become practically a general partner and to get his share of the larger dividends.

There remains the question of the proportionate interests of the investor or investors who contribute capital, and the operators who contribute knowledge, experience and work. It is impossible to say what this proportion should be, because it varies with the individual case. Where the investment of money is small, the contribution of experience large, and the business of a stable character, the investor's interest may fairly be made small; but, as the amount of his investment increases and the risks incident to the business are greater, his interest in the profits should increase, though never to the point where the operator's incentive to make the business a success is paralyzed by a feeling that he is simply working to make profits for someone else.

Something should be said as to two other classes of cases—first,

where an operator is himself prepared to contribute a half or more of the cash invested; and second, where money is needed for the extension of a plant which has both a substantial cost or replacement value and an established earning capacity. In the first instance, the amount of money which the operator needs to secure from the investor may be so small that he can safely give the investor bonds to secure his investment, such bonds being further secured by a sinking fund, or issued in serial form with a certain proportion maturing in each one of a period of years. If bonds are issued at all, they should certainly either be in a serial form, or provide for a sinking fund. It is inexpedient for the operator to have a mortgage for a considerable amount which falls due on a certain date. If his business has not been successful, he will probably not be in position to pay it. If the business has been successful, he will have need of all his money for extensions or additional working capital, and in either case the retention of his ownership is dependent upon his ability to secure an extension or renewal of the mortgage. Sinking funds are, as a rule, more expensive and less satisfactory than the serial repayment of bonds. In such a case, it is generally better to issue notes or bonds secured by a mortgage, with one-fifth or one-tenth of these notes or bonds maturing in each one of a period of five or ten consecutive years. The first maturity, however, should be several years from the date of issuance, to provide for the delays that may occur in realizing the anticipated earnings. If the additional capital required is more than it is prudent to put in the form of a fixed obligation, then recourse had better be had to the preferred stock plan. Such preferred stock, if sold at or below par, may very properly contain a provision providing for its redemption, at 105 or 110. Inasmuch as the operator in this case contributes not only his experience and skill, but also the major part of the investment and postpones returns upon his investment to returns upon that of the investor, he is justified in expecting the latter to take bonds or preferred stock upon a much better basis than if the investor were contributing the entire cash investment.

In the second class of cases, the operator is entitled to still more favorable terms, because an established earning capacity is the most valuable feature of an industrial investment. In an investment of that class, the cost of a plant is a comparatively minor

feature. An investor is foolish to make an investment in a plant which may be duplicated by a rival at a materially lower cost, but on the other hand there may be an investment of $100,000 which has no other value than its value as junk if it is not capable of earning money. Where an operator is in position to demonstrate that he has invested, for example, $200,000 in his plant; that both buildings and machinery have been kept up to date and are in no sense obsolete; that they could not be duplicated for less money; and that the plant has an earning capacity, as demonstrated through a period of average years of (say) $50,000 a year over and above the expenses of management; and he wants to secure $100,000 additional capital for extensions or improvements which will increase the earning capacity of the plant, he is entitled to expect that he will be able to get this money upon very reasonable terms. In such a case, the investor is dealing with an operator who has had actual experience in running a particular business at a particular place, and has shown not only that that business can be run in that place, but that it has been productive of large profits and may reasonably be expected to continue to make at least equal profits. The investor is therefore relieved of many of the doubts and uncertainties attending an enterprise which is new and untried as to either product, location or management.

It is hoped and believed that the above observations cover most of the fundamental points, but they fall far short of covering the whole subject. There are many risks of business which ought to be taken into account of which no mention has been made. There are many articles for which the demand may be local or temporary; and the business of manufacturing such articles is "extra-hazardous." A business which sells its product to a very few persons does not occupy so strong a position as one which has a multitude of customers. A business whose product is sold through a selling agency, without the identification of the manufacturer with the product, is less strongly intrenched than where there is such an identification. More important, perhaps, than anything else is the question of management. It is often said that a good manager will do better with a "yellow dog plant" than a poor manager with a good plant. The manager, however, may die, resign or become incapacitated. Reliance upon a single manager would therefore be reliance upon a very uncertain foundation. It is not

a question of the manager, but of the management. It is said to have been one of Andrew Carnegie's rules to have an "understudy" for every man of any importance in his organization, this understudy being trained in the general methods and principles of the organization, so that the organization and its management could go on continuously, without regard to the life, health or inclinations of individual employes. An established business gets a reputation among both employes and customers for fair dealing or the opposite. A reputation for fair dealing is a real asset. Where advantage has been taken of employes or of customers, large profits may be shown for a brief period of time, but a liability is being accumulated which will sooner or later become manifest. There are many items that do not show on the balance sheet.